

Articles

The \$10,000 Annual Per-Donee Gift Tax Exclusion*

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I. INTRODUCTION

Since 1932 the gift tax law has contained an annual per-donee exclusion, designed to "obviate the necessity of keeping an account of and reporting numerous small gifts."¹ At its inception the exclusion was fixed at 5,000 dollars per donee per year—"sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."² The 5,000 dollar allowance was in effect for the period 1932–1938; but because this amount was regarded as unreasonably large "in view of the frequency with which donors are induced by the exemption to build up estates of considerable size for the members of their families," the exclusion was reduced to 4,000 dollars for the period 1939–1942.³ In 1942, noting once again that the exclusion enabled donors to distribute large amounts of property free not only of gift tax but of estate tax as well, but acknowledging that "administrative difficulties" prevented abolition of the exclusion, Congress reduced the amount to 3,000 dollars.⁴ In 1981 this amount was increased to 10,000 dollars for post-1981 gifts to reflect the reduced purchasing power of the dollar.⁵ The dollar amounts applicable to earlier years, however, continue to control when gifts are cumulated over the taxpayer's lifetime in making the tentative tax computations required by Internal Revenue Code (IRC) section 2502(a).⁶

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1. S. REP. NO. 665, 72d Cong., 1st Sess. 41 (1932), *reprinted in* 1939–1 (Part 2) C.B. 496, 525. The short-lived 1924 gift tax provided an annual per-donor exemption of \$50,000 instead of a per-donee exclusion. Revenue Act of 1924, ch. 234, 43 Stat. 253, 314.

2. S. REP. NO. 665, 72d Cong., 1st Sess. 41 (1932), *reprinted in* 1939–1 (Part 2) C.B. 496, 525–26.

3. H. REP. NO. 1860, 75th Cong., 3d Sess. 61 (1938), *reprinted in* 1939–1 (Part 2) C.B. 728, 772 (recommending reduction to \$3,000); H. REP. NO. 2330, 75th Cong., 3d Sess. 17 (1938), *reprinted in* 1939–1 (Part 2) C.B. 817, 830 (conference compromise on \$4,000).

4. *See* H. REP. NO. 2333, 77th Cong., 2d Sess. 37 (1942), *reprinted in* 1942–2 C.B. 372, 403. The lifetime specific exemption—the statutory predecessor of the unified credit of current law—was reduced from \$50,000 (1932–1935) to \$40,000 (1936–1942), and then to \$30,000 (1943–1976). Revenue Act of 1942, ch. 619, 56 Stat. 798, 953.

5. JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 273 (1981).

Recognizing that trusts sometimes refer to IRC § 2503(b) (Supp. V 1981) in specifying the amount of property subject to a general power of appointment and that the statutory increase from \$3,000 to \$10,000 could defeat the settlor's expectation that any change would be less drastic, § 441(a)(2) of the Economic Recovery Tax Act of 1981, 95 Stat. 319, contains a transitional rule providing that the increase shall not apply to instruments executed before September 30, 1981, and not amended thereafter, if the power of appointment is defined in terms of the IRC § 2503(b) (Supp. V 1981) amount, unless a state law is enacted providing otherwise.

6. *See also* IRC § 2504(b) (Supp. V 1981).

Because the exclusion is computed on a per-donee basis, a taxpayer can give 10,000 dollars each to an unlimited number of donees without incurring any gift tax liability, and this process can be repeated year after year. For example, a taxpayer with 4 children can transfer 400,000 dollars to them during a 10-year period (10,000 dollars per child per year) without even reporting the transfers, and the tax-free amount can be 800,000 dollars if the taxpayer's spouse makes similar gifts or takes advantage of the split-gift privilege allowed by IRC section 2513.⁷

The year-by-year exclusion encourages donors to make gifts to a single donee in installments over a period of time, rather than transferring a large lump sum in one year. If the property to be donated is not readily divisible (*e.g.*, a work of art or Blackacre), the donor can achieve a spread-out by giving a suitably small fraction of the property to the donee each year until it has been transferred in full. If the donor wishes to confer full possession and enjoyment on the donee rather than transfer the property piecemeal, it may be feasible to sell it to the donee on credit and to cancel the donee's notes at the rate of 10,000 dollars per year (or 20,000 dollars, if the donor's spouse consents to the split-gift procedure sanctioned by IRC section 2513).⁸

Examples illustrating the systematic use of the annual exclusion to shield large transfers are regularly used by estate planners to demonstrate the tax advantages of transferring securities, real estate, and cash to the donor's children, as though the donor gave them nothing else—not even a ten-speed bicycle or a Teddy bear at Christmas. Thus, despite its origin as a method of protecting wedding and Christmas gifts against tax, the exclusion has come to be thought of as an estate planning device for transfers in addition to birthday and Christmas presents. Although this metamorphosis conflicts with the function of the annual exclusion as announced by Congress,⁹ the parental obligation to support minor children may encompass, under local law, a duty to recognize ceremonial occasions, such as birthdays, with appropriate items. If so, these transfers are not “gifts” within the meaning of IRC section 2501(a)(1) and, hence, do not eat into the 10,000 dollar annual exclusion allowed by IRC section 2503.

An important limitation on the use of the 10,000 dollar exclusion in estate planning, imposed by IRC section 2503(b) and discussed in detail below,¹⁰ is the disqualification of gifts of future interests in property. For example, if 100,000 dollars is transferred to a trust to accumulate the income and pay the principal and accumulated income to the beneficiary at the end of 20 years, no

7. Section 2513 (1976) requires the filing of a consent and, hence, implicitly requires split gifts to be reported regardless of amount.

8. See *Estate of Kelley v. Commissioner*, 63 T.C. 321 (1974) (sale to vendor's children and grandchildren upheld as bona fide; serial cancellations of notes constituted gifts of present interests, qualifying for exclusion) (*nonacq.*). But see Rev. Rul. 77-299, 1977-2 C.B. 343, 344 (rejecting result in *Estate of Kelley* and holding that serial forgiveness as “part of a prearranged plan” was “merely a disguised gift rather than a bona fide sale”).

9. See *supra* text accompanying notes 1-2.

10. See *infra* text accompanying notes 26-65.

exclusion is allowed; the gift is the full amount transferred—100,000 dollars, not 90,000 dollars.

Because the exclusion is computed donee-by-donee and year-by-year, the taxpayer cannot carry over underutilized amounts from one donee to another or from one year to another. For example, if A makes two gifts in 1982—12,500 dollars to X and 7,500 dollars to Y—the transfers are not aggregated and wiped out by two exclusions totalling 20,000 dollars; instead the transfer to X constitutes a taxable gift in the amount of 2,500 dollars. Similarly, if A gives Z 7,500 dollars in 1982 and 12,500 dollars in 1983, the latter transfer is a taxable gift of 2,500 dollars within the meaning of IRC section 2503.

The principal issues arising in applying the annual exclusion are: (1) Identification of the donee—a prerequisite to determining the number of allowable exclusions when two or more transferees are beneficially interested in the transferred property;¹¹ (2) determination of present and future interests, since gifts of future interests do not qualify for the exclusion;¹² and (3) application of the future interest restriction to gifts to minors, in view of state law limits on their legal power to use the transferred property.¹³

II. IDENTIFICATION OF DONEES

Since the 10,000 dollar exclusion applies to the gifts made during a calendar year by the donor “to any person,”¹⁴ the donee of every transfer must be identified to determine the number of persons generating permissible exclusions. The count is sometimes open to argument if gifts are made to legal entities or through conduits, or if the donor creates divided interests in the transferred property.

In *Helvering v. Hutchings*, the leading case in this field, the Supreme Court held that the beneficiaries of a trust, rather than the trust as a separate entity, are the persons to whom gifts in trust are made, observing that in common understanding “a gift is made to him upon whom the donor bestows the benefit of his donation.”¹⁵ The Court also pointed out that if the trust were viewed as the donee, donors could avoid the tax by dividing a proposed gift into amounts equal to the exclusion and establishing a series of separate trusts, each with a corpus equal to the exclusion, for the same beneficiary. Because some earlier cases had held that trusts qualified as donees in applying the exclusion, Congress eliminated the exclusion entirely for gifts in trust by a provision of the Revenue Act of 1938;¹⁶ but this statutory safeguard against tax avoidance became unnecessary when the Supreme Court decided *Hutchings*, and Congress repealed the provision in 1942.¹⁷

11. See *infra* text accompanying notes 14–25.

12. See *infra* text accompanying notes 26–65.

13. See *infra* text accompanying notes 66–121.

14. IRC § 2503(b) (Supp. V 1981).

15. *Helvering v. Hutchings*, 312 U.S. 393, 396 (1941).

16. See S. REP. NO. 1567, 75th Cong., 3d Sess. 41 (1938), reprinted in 1939–1 (Part 2) C.B. 779, 809.

17. See S. REP. NO. 1631, 77th Cong., 2d Sess. 243, reprinted in 1942–2 C.B. 504, 682.

Building on *Hutchings*' rationale, the Court of Appeals for the Ninth Circuit held in 1956 that the veil should be pierced when a gift is made to a corporation, revealing the shareholders as the true donees, each to the extent of his or her proportionate interest.¹⁸ This conclusion is a mixed blessing to donors, since it means that the gift tax applies only to the portion of the gift inuring to the benefit of shareholders other than the donor, but that the interests of the donee shareholders are future interests for which no exclusions are allowable¹⁹ and that no exclusion is allowed for the corporation itself.

Hutchings' veil-piercing approach also requires looking to the individuals who benefit when a gift takes the form of a tenancy in common, joint tenancy, or tenancy by the entirety and, a fortiori, when a gift is made to a partnership. In these cases an exclusion is allowable for each individual donee, unless the donee's interest is a future interest.²⁰ In *Hutchings*, however, the Court left open the possibility that a legal entity like a trust might be the donee for exclusion purposes in the case of gifts "for impersonal, public or charitable purposes where there are no designated or ascertainable first beneficiaries."²¹ This reservation is of merely theoretical interest in the case of most gifts for charitable and public purposes, since they are in any event deductible under IRC section 2522; but if the recipient organization does not qualify for the deduction, the IRS evidently treats the organization as the person to whom the gift is made within the meaning of IRC section 2503(b).²² This approach is consistent with the statement in the regulations that "a transfer made by an individual to a charitable, public or similar organization . . . may constitute a gift to the organization as a single entity."²³

Transfers may have to be realigned in applying the exclusion if a gift is made through an intermediary or is otherwise disguised. For example, if A transfers funds to B and C with instructions to give the money to X, a single gift to X occurs, generating one exclusion, rather than two gifts—each qualifying for a 10,000 dollar exclusion.²⁴ A more complicated but equally unavailing device to multiply exclusions is the reciprocal trust—for example, A creates a trust for A, Jr., and B creates a similar trust for B, Jr. A gives 10,000 dollars to each trust, and B similarly gives 10,000 dollars to each trust. At first blush, each of the four transfers is wiped out by a 10,000 dollar exclusion. But

18. *Heringer v. Commissioner*, 235 F.2d 149 (9th Cir.), *cert denied*, 352 U.S. 927 (1956); *see also* *Chanin v. United States*, 393 F.2d 972 (Ct. Cl. 1968); *Treas. Reg. § 25.2511-1(h)(1)* (1958); *Rev. Rul. 71-443*, 1971-2 C.B. 337.

19. *See infra* text accompanying notes 26-65.

20. *See* *Estate of Buder v. Commissioner*, 25 T.C. 1012 (1956) (piercing veil of tenancy by entirety). *But see* *Rev. Rul. 74-345*, 1974-2 C.B. 323 (because of husband's control over income from property held in tenancy by the entirety under Tennessee law, wife's interest does not qualify for exclusion).

21. 312 U.S. 393, 398 (1941).

22. *See* *Rev. Rul. 74-199*, 1974-1 C.B. 285 (criteria determining whether political committees are separate entities or must be aggregated for exclusion purposes). For the current status of political contributions, *see* *IRC § 2501(a)(5)* (Supp. III 1979); *see also* *IRC § 2522* (Supp. V 1981) (deduction for charitable contributions).

23. *Treas. Reg. § 25.2511-1(h)(1)* (1958).

24. *Cf. id.* § 25.2511-1(h)(2).

instead of being allowed two exclusions, A should be treated as making a single gift of 20,000 dollars to A, Jr., for which only one exclusion is allowable; and B should similarly be treated as making a single gift of 20,000 dollars to B, Jr., subject to one exclusion.²⁵ By stretching one's imagination to the limit, one could envision the possibility of four simultaneous but independent gifts in this situation; but in reality a separation of the gifts is virtually always mere camouflage, and if the transfers are actually interdependent, for either A or B to claim two exclusions would border on fraud.

III. GIFTS OF FUTURE INTERESTS

A. In General

When authorizing the per-donee exclusion in 1932, Congress denied any exclusion for gifts of future interests in property because of "the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts."²⁶ Congress might have dealt with these problems of proof by simply leaving them to the taxpayer, but the flat legislative rule of IRC section 2503(b) eliminates a source of argument and litigation; it is also consistent with the original function of the exclusion itself—to free Christmas, birthday, and other small gifts from tax—since future interests betoken estate planning, not spontaneous or ceremonial generosity that would be burdensome to record and to report to the government.

The term "future interests in property" was intended to encompass, according to the Senate Finance Committee's Report on the Revenue Act of 1932, "any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date."²⁷ In *United States v. Pelzer* the Supreme Court held that the statutory phrase precluded exclusions for gifts to the beneficiaries of a trust under which the income was to be accumulated for ten years and then distributed in equal shares to each of the grantor's grandchildren then living and 21 years of age, even though these interests were characterized as present rather than future interests under the law of Alabama, where the trust was created and administered.²⁸

25. See *Schultz v. United States*, 493 F.2d 1225 (4th Cir. 1974) (even if donor's intent in making transfers, rather than their objective effect, is controlling, directed verdict for IRS was justified because reasonable jury could have concluded only that donor intended to benefit his own children, not his brother's). For other aspects of reciprocal trusts, see generally *United States v. Estate of Grace*, 395 U.S. 316 (1969), and *Exchange Bank & Trust Co. of Fla. v. United States*, 49 A.F.T.R.2d (P-H) 82-1446 (Ct. Cl. 1981), *aff'd*, [Estate & Gift II] FED. TAXES (P-H) 148,337 (Fed. Cir. 1983).

26. S. REP. NO. 665, 72d Cong., 1st Sess. 41 (1932), reprinted in 1939-1 (Part 2) C.B. 496, 526. See generally Maxfield, *Troublesome Trust Powers Under Section 2503(b)*, 47 TAXES 457 (1969).

27. S. REP. NO. 665, 72d Cong., 1st Sess. 41 (1932), reprinted in 1939-1 (Part 2) C.B. 496, 526.

28. *United States v. Pelzer*, 312 U.S. 399 (1941); see also *Ryerson v. United States*, 312 U.S. 405 (1941) (two trustees could terminate trust and get one-half each of assets by joint action; held, each one's right was future interest; same for other interests conditioned on surviving specified persons).

In reaching this result, the Court first held that a uniform national meaning should be ascribed to the term "future interests in property," regardless of variations in local nomenclature:

In the absence of any statutory definition of the phrase we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of conveyancing, and there is no reason for supposing that the extent of the granted tax exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute. It is this purpose which marks the boundaries of the statutory command.²⁹

The Court then held that the intended function of the legislation required the interests of the beneficiaries in *Pelzer* to be treated as future interests:

Here the beneficiaries had no right to the present enjoyment of the corpus or of the income and unless they survive the ten-year period they will never receive any part of either. The "use, possession, or enjoyment" of each donee is thus postponed to the happening of a future uncertain event. The gift thus involved the difficulties of determining the "number of eventual donees and the value of their respective gifts" which it was the purpose of the statute to avoid.³⁰

Echoing the Senate Finance Committee's 1932 language, as well as *Pelzer's*, the regulations provide: "'Future interests' is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time."³¹

In harmony with these principles, a 1976 ruling states that an interest can be vested and marketable without qualifying as a present interest and that the power to borrow against donated property or to give it to members of the donee's family is insufficient to convert an otherwise future interest into a present one.³² Indeed, unless subject to a spendthrift clause or similar restraint, even the most future of future interests can be sold; and if this transfer conferred present interest status, the future interest restrictions of IRC section 2503(b) would have a very narrow jurisdiction. Items that have been classified as future interests under these principles include the indirect benefits conferred on shareholders by a gift to a closely-held corporation, invest-

29. 312 U.S. 399, 403 (1941).

30. *Id.* at 404; see also *Fondren v. Commissioner*, 324 U.S. 18, 26 (1945) (exclusion denied if enjoyment is postponed, even if administrative difficulties anticipated by Congress are not present because ultimate donees can be identified and their interests valued); *Welch v. Paine*, 120 F.2d 141, 142 (1st Cir. 1941).

31. Treas. Reg. § 25.2503-3(a) (1958); see Rev. Rul. 74-345, 1974-2 C.B. 323 (because of husband's control over income from property held in tenancy by entirety under Tennessee law, wife's interest does not qualify for exclusion). But see Rev. Rul. 78-168, 1978-1 C.B. 298 (gift of remainder interest to income beneficiary qualifies as present interest in state when merger, terminating trust, results from union of both interests in same person).

32. Rev. Rul. 76-360, 1976-2 C.B. 298 (gifts of nonincome-producing stock subject to two-year restriction on sale or other disposition; held, future interests despite limited power to pledge stock or give it to relatives).

ment letter stock, and a donee's right to obtain present enjoyment of property on request, but only if other donees join in the request.³³

B. *Interests in Income*

If pushed to a drily logical extreme, the rationale of *Pelzer* would deny any exclusion to the income beneficiary of a trust—at least for amounts to be paid in future years, since enjoyment of the income is postponed until it is earned by the trust and distributed to the donee. The IRS actually espoused this theory at one time.³⁴ In 1945, however, several lower court cases allowing an exclusion for gifts of income interests were apparently approved by the Supreme Court in *Fondren v. Commissioner*,³⁵ and this result is now accepted by the regulations, which provide that “an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property.”³⁶

Because income interests qualify for the exclusion while remainders are disqualified future interests, gifts of relatively modest amounts can have a curious effect, as illustrated by Example 1, which contrasts a gift of 30,000 dollars to a 5-year trust and a gift of the same amount to a 10-year trust, assuming in each case that A is to receive the income for the life of the trust and the remainder on its termination. As shown by line 5 of Example 1, the taxable gift is 22,418 dollars in the first case, but only 20,000 dollars in the second, even though the donee will obtain outright ownership earlier in the first case than in the second.³⁷ This result arises because the value of the present interest in the 5-year trust wastes part of the 10,000 dollar exclusion, while the income interest in the 10-year trust uses it in full. This paradox

33. See *id.*; see also *Skouras v. United States*, 188 F.2d 831 (2d Cir. 1951) (present enjoyment could be obtained only if 5 donees acted jointly; held, future interests); *Massey v. United States*, 82-1 U.S. Tax Cas. (CCH) ¶ 13,460 (E.D. Va. 1982) (exclusion denied for gift of interest in escrowed stock; held, subject to claims for indemnification growing out of corporate merger); *Chanin v. United States*, 393 F.2d 972 (Ct. Cl. 1968) (gift to closely-held corporation; economic benefits of shareholders constituted future interests); *Blasdel v. Commissioner*, 58 T.C. 1014, 1021-22 (1972) (donee's right to sell beneficial interest in trust does not turn restricted right to receive distributions into a present interest); *Hutchinson v. Commissioner*, 47 T.C. 680 (1967) (stock subject to restraint on sale, transfer or pledge for 10 years; held, restrictions created future interest) (*nonacq. on another issue*); Treas. Reg. § 25.2503-3(c) example 5 (1958) (when trust corpus consists of mortgaged real property and trustee must use income to service debt, right to receive income after mortgage is paid off constitutes future interest); Rev. Rul. 71-443, 1971-2 C.B. 337 (same as *Chanin*). But see *Grossinger's Estate v. Commissioner*, 44 T.C.M. (CCH) 443 (1982) (annuity commencing after death of prior donee constituted present interest, qualifying for exclusion because prior donee died one day after transfer; intervening one-day interest disregarded lest form be evaluated over substance).

34. See *Fischer v. Commissioner*, 45 B.T.A. 958, 962 (1941) (summarizing and rejecting IRS' argument), *aff'd*, 132 F.2d 383 (9th Cir. 1942).

35. 324 U.S. 18, 21 (1945).

36. Treas. Reg. § 25.2503-3(b) (1958). For the valuation of income interests, remainders, and annuities, see Treas. Reg. § 25.2512-9 (1970) (6% interest factor for post-1970 gifts); *id.* § 25.2512-5 (3-1/2% for pre-1971 gifts).

37. For other anomalies in the distinction between life interests and remainders, see *Charles v. Hassett*, 43 F. Supp. 432, 434-35 (D. Mass. 1942). See also *infra* text accompanying notes 50-53 for IRC § 2503(b) (1981), a legislative remedy for a similar paradox.

disappears, however, if the gift is large enough so that both life interests exceeded 10,000 dollars in value. For example, if the amount transferred in trust were 40,000 dollars, there would be a taxable gift of 30,000 dollars whether the trust was to last for 5 years or 10, as shown by Example 2.

EXAMPLE 1

Computation of Exclusion and Taxable Gifts—
Gift of \$30,000 in Trust.*

	<u>5-Year Trust</u>	<u>10-Year Trust</u>
1. Value of income interest	\$ 7,582	\$13,248
2. Less exclusion	<u>10,000</u>	<u>10,000</u>
3. Taxable gift of income	-0-	\$ 3,248
4. Taxable gift of remainder	<u>\$22,418</u>	<u>\$16,752</u>
5. Total taxable gifts	\$22,418	\$20,000

9*For values of income interests and remainders, see Treas. Reg. section 25.2512-9, Table B.

30EXAMPLE 2

Computation of Exclusion and Taxable Gifts—
Gift of \$40,000 in Trust.

	<u>5-Year Trust</u>	<u>10-Year Trust</u>
1. Value of income interest	\$10,110	\$17,664
2. Less exclusion	<u>10,000</u>	<u>10,000</u>
3. Taxable gift of income	\$ 110	\$ 7,664
4. Taxable gift of remainder	<u>\$29,890</u>	<u>\$22,336</u>
5. Total taxable gifts	\$30,000	\$30,000

To be viable in practice, the allowance of an exclusion for gifts of income interests must bow to normal powers of fiduciary administration, even if they impose minor restrictions on the donee's immediate access to the income from the transferred property. For example, life interests are not disqualified for the exclusion merely because income is distributed annually rather than daily or because the beneficiary must be living on the distribution date, even though these conventional requirements result in postponing (or, in the event of death, in defeating) enjoyment of the income accruing during a brief period of time.³⁸ Other common provisions that are consistent with the exclusion are spendthrift clauses, judicially reviewable powers to allocate receipts between

38. See, e.g., *Commissioner v. Kempner*, 126 F.2d 853, 854 (5th Cir. 1942) (distribution "as soon as reasonably practicable"); *Edwards v. Commissioner*, 46 B.T.A. 815, 820 (1942) (distribution on dates determined by trustee to be "convenient and practicable but at least annually"), *aff'd on other issues*, 135 F.2d 574 (7th Cir. 1943).

principal and interest, and the inclusion of after-born members of a donee class when income is distributed.³⁹

A hazard created by class gifts, however, is the possibility that the interests of the members living when the gift is made, though qualifying as present interests, may be difficult or impossible to value because their shares can be reduced by the entry of after-born members of the class in later years.⁴⁰ Moreover, one should note that an initial delay in the date when an income interest takes effect has been held to disqualify an otherwise qualified interest, such as a 20 year-old-donee's right to receive the income of a trust starting at age 21.⁴¹ In providing that income interests qualify for the exclusion, the regulations speak of "an unrestricted right" to the income from property,⁴² thereby implying that restricted income interests are future interests for which an exclusion is not allowable. This implication is illustrated by examples in the regulations denying the exclusion to trusts authorizing the trustee to withhold income from the beneficiary for any period deemed advisable, or to divide the income among the named beneficiaries in such proportions as the trustee deems proper.⁴³

If the trustee's discretion is subject to an enforceable external standard, such as a provision requiring distribution of sufficient income to maintain the beneficiary at his customary standard of living, the beneficiary's right to receive the contemplated amount is a present interest, but an exclusion may nevertheless be denied if the value of the interest is not ascertainable. In

39. See *Commissioner v. Lowden*, 131 F.2d 127 (7th Cir. 1942) (inclusion of after-born members of class); *Mercantile Safe-Deposit & Trust Co. v. United States*, 311 F. Supp. 670 (D. Md. 1970), and cases there cited (distinction between judicially reviewable and wholly unfettered powers to allocate); *Swetland v. Commissioner*, 37 T.C.M. (CCH) 249 (1978) (allocation power subject to review under local law); *Martinez v. Commissioner*, 67 T.C. 60, 71 (1976) (power to allocate treated as judicially reviewable despite careless inclusion in trust instrument of "commonplace boilerplate trust powers" purporting to confer uncontrolled discretion); Rev. Rul. 54-344, 1954-2 C.B. 319 (spendthrift clause permissible). But see Rev. Rul. 77-358, 1977-2 C.B. 342 (value of income interest not ascertainable when all gains and losses from sale of trust assets are credited or charged to income).

40. See Rev. Rul. 55-678, 1955-2 C.B. 389 (exclusion allowed when present interest had ascertainable value after taking into consideration all possible contingencies). For a similar view, see Rev. Rul. 55-679, 1955-2 C.B. 390. See also Rev. Rul. 75-415, 1975-2 C.B. 374 (income interests of two donees would diminish if third donee terminated student status; exclusions must be based on first two donees' assured rights to one-third of income, since their rights to one-half each of the income may terminate on an event whose occurrence is not mathematically predictable).

41. *Hessenbruch v. Commissioner*, 178 F.2d 785 (3d Cir. 1950); *Jardell's Estate v. Commissioner*, 24 T.C. 652 (1955) (gift of mineral property, effective for production beginning three months after date of gift; disqualified); see also *Braddock v. United States*, 33 A.F.T.R.2d (P-H) 1394 (N.D. Fla. 1973) (not officially reported) (gift of real estate constituted future interest because property was subject to leasehold terminating 3 months after gift and interim income was retained by donor rather than made available to donees); *Klein v. Commissioner*, 34 T.C.M. (CCH) 1113 (1975) (accumulation until donee reaches age 16 or enters high school, college, or university, whichever occurs first; held, future interest); Rev. Rul. 75-506, 1975-2 C.B. 375 (gift of income from trust in equal shares to two beneficiaries, and of entire income to survivor; held, each donee's right to one-half income is a present interest, but right to receive additional half on surviving the other is a future interest because postponed until other beneficiary's death).

42. See *supra* text accompanying note 36.

43. Treas. Reg. § 25.2503-3(c) examples 1 (power to withhold) and 3 (power to determine proportions) (1958); see also *Blasdel v. Commissioner*, 58 T.C. 1014 (1972) (distribution of income permissible only with unanimous consent of 20 beneficiaries or consent of majority of beneficiaries and of directors of specified bank; held, future interests), *aff'd per curiam*, 478 F.2d 226 (5th Cir. 1973).

*Commissioner v. Disston*⁴⁴ the Supreme Court assumed *arguendo* that a fiduciary power to distribute "such income [from the transferred property] as may be necessary for the education, comfort and support"⁴⁵ of certain minors imposed a duty to make such distributions even though the minor was adequately supported by parents, personal earnings, or other financial sources, but nevertheless denied the exclusion:

The existence of duty so to apply the income gives no clue to the amount that will be needed for that purpose, or the requirements for maintenance, education and support that were foreseeable at the time the gifts were made. In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future. The taxpayer claiming the exclusion must assume the burden of showing that the value of what he claims is other than a future interest That burden has not been satisfied in this case.⁴⁶

In particular cases, however, taxpayers may be able to avoid disqualification under *Disston* by showing that "a steady flow of some ascertainable portion of income" will be required to meet the trustee's obligation because, for example, the trust income is the primary or sole source of support for a person without other resources.⁴⁷ In this situation the value at the time of the gift of the ascertainable flow of income qualifies for the exclusion.⁴⁸

C. Effect of Power to Invade Principal

If the corpus of a trust can be invaded for the benefit of the remainderman, the value of the income beneficiary's interest is unascertainable, unless exercise of the power is restricted by an enforceable external standard and the amount that will be left for the income beneficiary can be estimated with reasonable accuracy.⁴⁹ In the absence of an enforceable standard, it does not matter whether the income interest is viewed as a present interest whose value cannot be ascertained or as a future interest because continued possession and enjoyment of the income is dependent on future unpredictable events; on either theory the interest does not qualify for an exclusion.

This outcome is clearly warranted if the power to invade is exercisable for the remainderman, since the income interest is no more secure than it

44. 325 U.S. 442 (1945).

45. *Id.* at 448-49.

46. *Id.*

47. See *Morgan v. Commissioner*, 42 T.C. 1080, 1088-93 (1964) (distributions to provide for "health, comfort, maintenance, and support" of retarded child treated as mandatory), *aff'd per curiam*, 353 F.2d 209 (4th Cir. 1965), *cert. denied*, 384 U.S. 913 (1966).

48. *Id.*

49. See, e.g., *Kniep v. Commissioner*, 172 F.2d 755 (8th Cir. 1949) (exclusion allowed, but not in excess of value of income interest, reduced annually by maximum invasion permitted by trust instrument); *Jones v. Commissioner*, 29 T.C. 200 (1957) (power to invade disregarded because possibility of exercise was negligible).

would be if the trust provided for an accumulation of income for the benefit of the remainderman, subject to a discretionary power in the trustee to advance income to the so-called income beneficiary. On the other hand, if the income beneficiary is also the remainderman, an exercise of the power to invade corpus merely speeds up the date when the income beneficiary will enjoy both the principal and the income; it makes little sense to deny the exclusion because of this possibility of acceleration.

For this reason IRC section 2503(b) was enacted in 1954 to protect the status of an interest that otherwise qualifies for the exclusion.⁵⁰ Under IRC section 2503(b) a power to diminish a present interest in property is disregarded in applying the exclusion, provided no part of the interest will pass to any other person at any time.⁵¹ A discretionary power to distribute principal to other persons, such as members of the income beneficiary's family, continues to be fatal, however, because the power makes it impossible to value the income interest,⁵² and IRC section 2503(b) is inapplicable because exercise of the power shifts benefits from the income beneficiary to others.⁵³

In some small trusts, application of section 2503(b) can increase the exclusion without any significant change in dispositive results. For example, if 20,000 dollars are transferred to a 10-year trust, income to A (a 15-year-old female) for 10 years, remainder to her on termination, the taxable gift consists only of the remainder, worth 11,168 dollars, since the income interest (worth 8,832 dollars) qualifies for the exclusion. If, however, the trust is to continue for A's life, subject to a right in A to demand the corpus at the end of 10 years, the income interest would be worth 19,063 dollars, 10,000 dollars of which would qualify for the exclusion, leaving a taxable gift of only 10,000 dollars—the unexcluded portion of the income interest (9,063 dollars) plus the unqualified remainder (worth 937 dollars). If the gift consisted of 40,000 dollars and the donor's spouse consented to split-gift treatment under IRC section 2513, the taxable gifts would be 22,336 dollars for a 10-year trust, but only 20,000 dollars for a trust for life, subject to A's power to demand the corpus at the end of 10 years, as shown by Example 3.

50. See S. REP. NO. 1622, 83d Cong., 2d Sess. 478 (1954). For a similar anomaly, which remains uncorrected by legislation, see *supra* Example 1. For prior law, see *Herrmann's Estate v. Commissioner*, 235 F.2d 440 (5th Cir. 1956) (exclusion denied when trustee could distribute corpus to income beneficiary for education, maintenance, and support to extent deemed necessary or advisable in trustee's sole judgment).

51. See Treas. Reg. §§ 25.2503-3(b) sentence 3, 25.2503-3(c) example 4 (1958).

52. S. REP. NO. 1622, 83d Cong., 2d Sess. 127 (1954).

53. *Funkhouser's Trusts v. Commissioner*, 275 F.2d 245 (4th Cir.), *cert. denied*, 363 U.S. 804 (1960); *Hockman v. United States*, 327 F. Supp. 332 (D. Md. 1971); see also *Schayek v. Commissioner*, 33 T.C. 629 (1960) (IRC § 2503(b) does not validate income interests of three beneficiaries when trustee could advance principal to any of them, a possibility that rendered unascertainable the value of all income interests); *Newlin v. Commissioner*, 31 T.C. 451 (1958) (power to terminate trust did not render value of income interest unascertainable when income beneficiary's consent to termination was required).

EXAMPLE 3

Effect of Income Beneficiary's Power to Invade Corpus—IRC Section 2503(b)—
Gift of \$40,000, Subject to Split-Gift Consent*

	<u>10-Year Trust</u>	<u>Trust for Life, Subject to Power to Invade at End of 10 Years</u>
1. Value of income interest	\$17,664	\$38,126
2. Less 2 exclusions	<u>20,000</u>	<u>20,000</u>
3. Taxable portion of income interest	-0-	\$18,126
4. Value of remainder	<u>\$22,336</u>	<u>\$ 1,874</u>
5. Taxable gifts	\$22,336	\$20,000

*For values of income interests and remainders, see Treas. Reg. section 25.2512-9, Tables A and B.

D. *Income Interests in Nonproductive Property and Stock of Closely-Held Corporations*

Since the exclusion cannot exceed 10,000 dollars or the value of the present interest to which it is applied, whichever is less, it is necessary to value income interests. This calculation is regularly done by the use of tables prescribed by the regulations, which assume a six percent interest factor, and when survivorship or mortality is concerned, by the use of standard actuarial data.⁵⁴ In any individual case, of course, the property may produce a greater or lesser yield and death may occur sooner or later than the tables assume. But the tables provide a rough and ready path through an area that is "fraught with speculation and uncertainty";⁵⁵ the government "is in business with enough different taxpayers so that the law of averages has ample opportunity to work,"⁵⁶ and individual taxpayers, who do not get the benefit of the law of averages, are at least spared the legal and accounting expenses of proving each case from scratch.

In recent years, however, the IRS has been successful in denying exclusions to income interests in nonproductive property, especially the non-dividend-paying stock of closely-held corporations, on the theory that the actuarial tables "are designed to calculate the value of a present interest, not to create it"⁵⁷ and, hence, can be used only if the taxpayer first proves that some income will be received by the trust beneficiaries.⁵⁸ In the same vein, the Court

54. See Treas. Reg. § 25.2512-9 (1970) (tables for post-1970 gifts).

55. *McMurtry v. Commissioner*, 203 F.2d 659, 666 (1st Cir. 1953); see also *Hipp v. United States*, 215 F. Supp. 222, 226-28 (W.D.S.C. 1962).

56. *Gelb v. Commissioner*, 298 F.2d 544, 552 (2d Cir. 1962).

57. *Maryland Nat'l Bank v. United States*, 609 F.2d 1078, 1081 (4th Cir. 1979).

58. See, e.g., *id.* (no exclusion for gift of income interest in real estate with consistent history of losses, despite rosy future for development purposes); *Berzon v. Commissioner*, 534 F.2d 528 (2d Cir. 1976) (same for

of Appeals for the Ninth Circuit upheld the denial of an exclusion for gifts of interests in real estate held for the donors under a "partnership and trust agreement" that gave the trustees complete discretion to distribute or accumulate income.⁵⁹ Although the donors gave the donees fractional shares of their interests under the agreement, the donees could not sell the transferred rights or receive any income from the underlying property unless the trustees exercised their discretionary authority to make distributions.⁶⁰

The IRS, however, evidently accepts the actuarial tables set out in the regulations as controlling, even if the underlying property produces a below-normal current yield, as in growth stocks; this means that the revenues at stake in this persistent effort to disqualify a limited category of nonproductive assets must be minimal. For example, if the donated property yields only 1,360 dollars a year, the value of the income interest in a 10-year trust is 10,009 dollars—enough to make full use of the exclusion.

One should also note that the Tax Court, despite its hospitality to the government's campaign, has refused to disallow the exclusion merely because the trustee is empowered to invest in nonproductive property, unless the power either has been, or is likely to be, exercised to restrict distributions to the income beneficiaries.⁶¹

E. Contract Rights to Future Payments

Although the hallmark of a present interest is "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property," while the postponement of use, possession, or enjoyment until a future date betokens a future interest,⁶² the regulations provide that gifts of bonds and notes qualify for the exclusion even though the interest is not payable until maturity.⁶³ The same is true of a gift of a life insurance policy and of the payment of premiums on a previously issued policy payable to the donee, even though nothing will be paid until the insured's death.⁶⁴

stock of closely-held corporation, when payment of dividends was not intended or financially feasible and shareholders' agreement precluded sale of stock and investment of proceeds in income-producing assets); *Stark v. United States*, 477 F.2d 131 (8th Cir.), cert. denied, 414 U.S. 975 (1973) (same). But see *Rosen v. Commissioner*, 397 F.2d 245 (4th Cir. 1968) (exclusion allowed when trustees could sell nondividend-paying closely-held stock but believed prospect of future dividends warranted retention; actuarial tables control except in extraordinary circumstances). In Rev. Rul. 69-344, 1969-1 C.B. 225, the IRS ruled that it would not follow *Rosen*.

59. *Hamilton v. United States*, 553 F.2d 1216, 1217 (9th Cir. 1977).

60. *Id.*

61. *Swetland v. Commissioner*, 37 T.C.M. (CCH) 249 (1978).

62. Treas. Reg. § 25.2503-3(a), (b) (1958).

63. *Id.* § 25.2503-3(a).

64. *Id.*; *id.* § 25.2511-1(h)(8); see also Rev. Rul. 76-490, 1976-2 C.B. 300 (employer's payment of premiums on group term policy held by irrevocable trust created by employee is indirect gift of present interest by employee to assignee of policy); Rev. Rul. 55-408, 1955-1 C.B. 113 (absence of cash surrender value does not bar exclusion). But see *Roberts v. Commissioner*, 143 F.2d 657 (5th Cir. 1944) (life insurance policy rules do not cover "guaranteed endowment annuity" policies under which payments are not due until future years and then only to surviving annuitants; exclusion denied).

While outright gifts of assets of this type qualify for the exclusion, dispositions that create sequential temporal interests or impose similar restrictions on the donee's immediate possession and enjoyment of the property may result in disallowance of an exclusion. For example, if a life insurance policy (or other nonproductive property) is transferred in trust to pay the income from the property to A for life and the remainder to B, A's income interest does not qualify for an exclusion unless the trustee can, and is likely to, sell the transferred property and reinvest the proceeds in assets producing current income; otherwise no income will be available for distribution to A until the policy matures, meaning that A's interest rights constitute a future interest.⁶⁵

IV. GIFTS TO MINORS

A. Outright Gifts

In applying the annual per-donee exclusion, the most troublesome issues have been generated by gifts to minors, primarily because (1) donors are often reluctant to give up all strings when making gifts to young children; (2) minors are subject to legal disabilities in dealing with their assets; (3) banks, corporate transfer agents, and other institutions are often unwilling to engage in transactions with minors that may be disaffirmed when the minor reaches his or her majority; and (4) trustees and legally appointed guardians holding assets for minors ordinarily have discretionary authority either to apply the income for the minor's benefit or to accumulate it for later distribution. Taken in combination, these facts of life often put the exclusion in jeopardy. This is especially true since the Supreme Court held in *Fondren v. Commissioner*, decided in 1945, that a gift in trust for a minor created a future interest, which did not qualify for the exclusion, because the trustee could either apply the income and principal for the minor's maintenance, education, and support or distribute the accumulated income and principal to the beneficiary in installments when he reached age 25, 30, and 35.⁶⁶ Not long after *Fondren* was decided, the IRS suggested in a Tax Court case concerning several minor donees that "the fact of minority and consequent legal disability of the donees resulted in the postponement of enjoyment which characterizes future interests"—a theory that, as the court observed, would deny the exclusion to all gifts to minors.⁶⁷ Indeed,

65. Treas. Reg. § 25.2503-3(a) last sentence, -3(c) example 2 (1958); Rev. Rul. 79-47, 1979-1 C.B. 312 (premiums paid by employer on employee's group term insurance; exclusion denied). See *supra* text accompanying note 61 (regarding gifts of nonproductive property); see also *Perkins v. Commissioner*, 1 T.C. 982 (1943) (irrevocable designation of spouse as beneficiary of insurance policy constituted gift of only one-half of cash surrender value, when premiums were paid with community funds; exclusion denied because beneficiary was subject to installment settlement option and could not draw down cash surrender value or borrow against policy) (*nonacq.*).

66. *Fondren v. Commissioner*, 324 U.S. 18 (1945).

67. *Daniels v. Commissioner*, 10 T.C.M. (CCH) 147 (1951) (the transfer was construed as an outright gift rather than as a trust, despite the donor's use of "trust" language); *Heller v. Commissioner*, 41 B.T.A. 1020, 1033 (1940); see also S. REP. NO. 1622, 83d Cong., 2d Sess. 127 (1954) (doubts regarding application of exclusion to gifts to child's guardian if guardian is legally responsible for child's support); Fleming, *Gifts for the Benefit of*

when the postponed-enjoyment standard is applied to gifts to minors, arguably even the most commonplace Christmas and birthday gifts, which the exclusion was designed to shield against tax, would fail the test. What child has not been warned by a parent: "If you don't behave, I'll take your electric train away and you won't see it again until you grow up!"?

After hinting that even outright gifts to minors are necessarily future interests and, hence, cannot qualify for an exclusion, the IRS backed down in 1954 by ruling that:

[a]n unqualified and unrestricted gift to a minor, with or without the appointment of a legal guardian, is a gift of a present interest; and disabilities placed upon minors by State statutes should not be considered decisive in determining whether such donees have the immediate enjoyment of the property or the income therefrom within the purport of the Federal gift tax law. . . . In the case of an outright and unrestricted gift to a minor, the mere existence or nonexistence of a legal guardianship does not of itself raise the question whether the gift is of a future interest. . . . It is only where delivery of the property to the guardian of a minor is accompanied by limitations upon the present use and enjoyment of the property by the donee, by way of a trust or otherwise, that the question of a future interest arises.⁶⁸

A necessary implication of this ruling is that unrestricted gifts to a legally appointed guardian for a minor qualify for the exclusion, even though local law limits the guardian's use of the funds, for example, by permitting expenditures for the ward's maintenance and education only if the parents cannot provide adequate support and the disbursement is judicially approved in advance.⁶⁹ Moreover, in determining whether conditions prescribed by the donor's deed of gift impose "limitations upon the present use and enjoyment of the property by the donee,"⁷⁰ within the meaning of the 1954 ruling, the courts have held in several cases that the particular disputed provisions relieved the guardian from state-imposed restrictions, thus strengthening rather than weakening the case for an exclusion.⁷¹

The status of trusts subjecting the trustee to the rules that state law prescribes for guardians is not wholly clear. If the trustee not only can, but must, act like a guardian, an exclusion should be allowed, since such a transfer then is tantamount to a transfer to a guardian because of the donee's present enjoyment.⁷² On the other hand, if the trustee is given the same discretionary authority as a guardian, but has additional powers under the trust indenture to

Minors, 49 MICH. L. REV. 529 (1951); Newman, *Tax and Substantive Aspects of Gifts to Minors*, 50 CORNELL L.Q. 446 (1965); Rogers, *Some Practical Considerations in Gifts to Minors*, 20 FORDHAM L. REV. 233 (1951).

68. Rev. Rul. 54-400, 1954-2 C.B. 319.

69. *Briggs v. Commissioner*, 34 T.C. 1132 (1960).

70. *Id.* at 1135.

71. *Id.* at 1132 (right to act without prior court approval); see *United States v. Baker*, 236 F.2d 317 (4th Cir. 1956); see also *Morgan v. Commissioner*, 42 T.C. 1080, 1093 (1964) (gift to trust should be judged by same standard as though made to guardian), *aff'd per curiam*, 353 F.2d 209 (4th Cir. 1965).

72. See Rev. Rul. 59-78, 1959-1 C.B. 690 (citing *United States v. Baker*, 236 F.2d 317 (4th Cir. 1956), and distinguishing *Stifel v. Commissioner*, 197 F.2d 107 (2d Cir. 1952)); Rev. Rul. 54-91, 1954-1 C.B. 207 (revoked by Rev. Rul. 73-405, 1973-2 C.B. 321).

withhold possession or enjoyment of the property from the minor, the gift may well create a future interest rather than a present one.⁷³ In several cases, however, the courts have rescued untutored donors from this pitfall by holding that an outright gift to the minor was intended even though the dispositive instrument purported to create a trust.⁷⁴

B. Demand Trusts

An ingenious device to obtain an exclusion for a discretionary accumulation trust for a minor beneficiary by giving the minor or a guardian acting on the minor's behalf the right to demand distribution of the transferred property has been the subject of extensive analysis by several courts in a series of cases, culminating in a 1968 decision by the Court of Appeals for the Ninth Circuit, *Crummey v. Commissioner*,⁷⁵ which held that the exclusion was allowable. The IRS accepted this outcome in a 1973 ruling.⁷⁶ The demand clause in *Crummey* provided that whenever an addition was made to a trust, each minor beneficiary, or each guardian acting for the beneficiary, could obtain a distribution of the amount transferred or 4,000 dollars,⁷⁷ whichever was less. The court held that this right was a present interest even though no guardian had been appointed and one of the beneficiaries was only 11 years old—too young under local law to file a petition for the appointment of a guardian.⁷⁸ The donor, therefore, was entitled to an exclusion for each donee whenever amounts were added to the trust.

The IRS conceded that an exclusion was allowable for two of the beneficiaries, since they were over age 21, and it would evidently have allowed exclusions for the other two, despite their minority, if guardians had actually

73. See *Benton v. Commissioner*, 27 T.C.M. (CCH) 332 (1968) (power to act without resort to guardianship proceeding); *Katz v. Commissioner*, 27 T.C. 783 (1957).

74. See, e.g., *Messing v. Commissioner*, 48 T.C. 502 (1967) (gifts to parents "in trust for" their children treated as outright gifts); *Daniels v. Commissioner*, 10 T.C.M. (CCH) 147 (1951).

75. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

76. Rev. Rul. 73-405, 1973-2 C.B. 321 (revoking a contrary earlier ruling, Rev. Rul. 54-91, 1954-1 C.B. 207); see also Rev. Rul. 80-261, 1980-2 C.B. 279 (exclusion allowed on pro rata basis when there are several beneficiaries and the principal is insufficient to satisfy all permissible demands). But see *Blasdel v. Commissioner*, 58 T.C. 1014 (1972) (donee's power to demand distributions jointly with other donees did not constitute present interest when unanimity was required). *Skouras v. Commissioner*, 188 F.2d 831 (2d Cir. 1951), had earlier taken the same position. The principal pre-*Crummey* cases were *Kieckhefer v. Commissioner*, 189 F.2d 118 (7th Cir. 1951) (exclusion allowed since it would apply if identical demand privilege had been vested in adult), and *Stifel v. Commissioner*, 197 F.2d 107 (2d Cir. 1952) (exclusion denied when no guardian had been appointed). See generally *Mason, An Analysis of Crummey and the Annual Exclusion*, 65 MARQ. L. REV. 573 (1982).

77. 397 F.2d 82, 83 (9th Cir. 1968). If the demand provision was included solely to ensure a full exclusion, a \$3,000 limit on the amount to be distributed for the year before the court, or a \$10,000 limit under post-1981 law, could have been imposed. When the exclusion was increased to \$10,000, Congress enacted a transitional rule, set out in § 441(c)(2) of Public Law 97-34 (not incorporated in the Internal Revenue Code), under which the increase in the exclusion does not apply to preexisting *Crummey* trusts if the demand power is "expressly defined in terms of, or by reference to, the amount of the gift tax exclusion under section 2503(b) of the Internal Revenue Code," subject to certain exceptions. For discussion of this transitional rule, see *Natbony, The Crummey Trust and "Five and Five" Powers After ERTA*, 60 TAXES 497 (1982).

78. 397 F.2d 82, 86-88 (9th Cir. 1968).

been appointed for them.⁷⁹ The court implied that a distinction between adult and minor donees was not warranted:

As we visualize the hypothetical situation [in the absence of a guardian], the child would inform the trustee that he demanded his share of the additions up to \$4,000. The trustee would petition the court for the appointment of a legal guardian and then turn the funds over to the guardian. It would also seem possible for the parent to make the demand as natural guardian. This would involve the acquisition of property for the child rather than the management of the property. It would then be necessary for a legal guardian to be appointed to take charge of the funds. The only time when the disability to sue would come into play, would be if the trustee disregarded the demand and committed a breach of trust. That would not, however, vitiate the demand.⁸⁰

Of course, in *Crummey* the beneficiaries, whether adults or minors, were obviously not expected to exercise their rights under the demand clause; if that had been contemplated, the donor would undoubtedly have made outright gifts to the beneficiaries rather than have put the funds into the trust and watch them flow out immediately thereafter. The donor's expectation that the funds would remain in the trust was heightened by the demand clause itself, since once the time for making a demand expired (December 31 of the year in which the relevant addition to the trust was made), the amount that could have been demanded became subject to the trustee's discretionary powers until the donees reached the ages specified by the trust instrument.⁸¹

The court in *Crummey* was not oblivious to reality:

Although under our interpretation neither the trust nor the law technically forbid a demand by the minor, the practical difficulties of a child going through the procedures seem substantial. In addition, the surrounding facts indicate the children were well cared for and the obvious intention of the trustors was to create a long term trust. No guardian had been appointed and, except for the tax difficulties, probably never would be appointed. As a practical matter, it is likely that some, if not all, of the beneficiaries did not even know that they had any right to demand funds from the trust. They probably did not know when contributions were made to the trust or in what amounts. Even had they known, the substantial contributions were made toward the end of the year so that the time to make a demand was severely limited. Nobody had made a demand under the provision, and no distributions had been made. We think it unlikely that any demand ever would have been made.⁸²

Given this assessment of the facts, the allowance of an exclusion may at first seem unrealistic, but *Crummey* is entirely harmonious with the rules governing the per-donee exclusion, since make-believe is their principal characteristic. For example, the exclusion is routinely claimed and allowed for so-called outright gifts of cash and securities to children who are too young

79. *Id.* at 87.

80. *Id.*

81. *Id.* at 83.

82. *Id.* at 87-88.

even to say "thank you" by parents who intend to preserve the property and accumulate the income until the donee is of age and who, despite their status as natural guardians of the child's person, have little authority under local law to make any other disposition of the assets without being appointed guardians of the child's property.

Crummey can also be defended from a more technical perspective. The Treasury has consistently argued in many tax contexts that the right to get property on request is tantamount to outright ownership;⁸³ that is why it conceded in *Crummey* that exclusions were warranted under the demand clause in the case of the adult beneficiaries. Having ruled in 1954 that the legal disability of minors does not prevent outright gifts to them from qualifying for the exclusion even if no guardian has been appointed,⁸⁴ the IRS had no valid ground for insisting in *Crummey* that a guardian was necessary to convert minors' rights under the demand clause into the equivalent of outright gifts. In 1973 the IRS accepted this line of reasoning by ruling that an exclusion is warranted if a minor has the right to demand a distribution from an otherwise discretionary trust, even in the absence of a legally appointed guardian, provided no impediment exists under the trust or local law to that appointment.⁸⁵ It is not clear, however, how the IRS would respond if the minor is ignorant of the demand clause or of the right to apply for the appointment of a guardian. In a 1981 ruling discussing a demand trust for the benefit of an adult beneficiary, the IRS held that "the donor's intent, as gleaned from the circumstances of the transfer, is a relevant consideration in determining when the rights actually conferred are meant to be enjoyed"⁸⁶ and that the grantor's failure to inform the beneficiary of the demand privilege before it expired at the end of the year of the transfer made it "illusory,"⁸⁷ with the result that the gift consisted of a future interest, which did not qualify for the exclusion.⁸⁸

C. Statutory Trusts for Minors—IRC Section 2503(c)

Because of pre-1954 doubts whether gifts to minors were present interests, qualifying for the annual per-donee exclusion if the minor's access to the property was restricted for want of a legally appointed guardian of the minor's property or because of the guardian's discretionary powers under local law,⁸⁹ Congress enacted IRC section 2503(c) as part of the 1954 Code. Under this provision a gift to a person under the age of 21 when the transfer is made is not considered a gift of a future interest if the property and the income therefrom

83. See, e.g., *Burnet v. Guggenheim*, 288 U.S. 280 (1933); *Corliss v. Bowers*, 281 U.S. 376 (1930); *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir.), cert. denied, 324 U.S. 871 (1945).

84. Rev. Rul. 54-91, 1954-1 C.B. 207.

85. Rev. Rul. 73-405, 1973-2 C.B. 321.

86. Rev. Rul. 81-7, 1981-1 C.B. 474, 474.

87. *Id.*

88. *Id.*

89. See S. REP. NO. 1622, 83d Cong., 2d Sess. 127 (1954).

(1) may be expended by or for the benefit of the donee before age 21, and, (2) to the extent not so expended, (a) will pass to the donee at age 21 and (b) if death occurs before then, will be payable to the donee's estate or as the donee appoints under a general power of appointment.

Although many of the doubts that led Congress to enact IRC section 2503(c)⁹⁰ have been resolved in the taxpayer's favor by post-1954 developments, it is a popular device because it qualifies gifts for the exclusion even though the donee's possession and enjoyment of the donated property are subject to discretionary powers that would otherwise require the gift to be classified as a future interest—for example, uncontrolled discretion in the trustee to use the fund to support the minor or to accumulate it until the minor reaches age 21. Qualifying transfers often take the form of trusts, but IRC section 2503(c) applies to any transfer satisfying the conditions summarized above, including transfers under state custodianship laws.⁹¹

The principal issues arising in the application of IRC section 2503(c) are examined below in the context of the relevant statutory requirement.

1. Expenditure of Property and Income by or for Donee Before Age Twenty-one

In requiring that the property and the income therefrom may be expended by or for the benefit of the donee before age 21, IRC section 2503(c)(1) does not look to the probability of expenditures, but only to the right of the donee, trustee, or custodian to make such expenditures; thus a trust can qualify even though all income can and probably will be accumulated, provided expenditures before the donee reaches age 21 are permissible.⁹² Moreover, in referring to expenditures "by, or for the benefit of, the donee," IRC section 2503(c)(1) does not require that both the donee and the trustee (or custodian) have expenditure authority; the discretion can be vested solely in the trustee or custodian if the donor so wishes—and he usually does.⁹³

Another ambiguity in the statutory language relating to expenditures "for the benefit of" the minor is resolved by the regulations, with judicial support,

90. See Rev. Rul. 73-405, 1973-2 C.B. 321; Rev. Rul. 54-400, 1954-2 C.B. 319. For the continuing possibility of an exclusion for gifts in trust for minors under IRC § 2503(b) (Supp. V 1981), without regard to the special rules of IRC § 2503(c) (1976), see Treas. Reg. § 25.2503-4(c) (1958).

91. See *infra* text accompanying notes 119-21. Cf. *Faulkner v. Commissioner*, 41 B.T.A. 875, 879 (1940) (exclusion allowed, before enactment of IRC § 2503(c) (1976), for gift to unborn child; acceptance, as required for completed gift at common law, presumed). But see Rev. Rul. 67-384, 1967-2 C.B. 348 (trust for unborn child does not qualify, since neither IRC § 2503(c)(1) (1976) nor § 2503(c)(2) (1976) could be fulfilled if the fetus died before birth).

For attempts to reform badly drafted documents to satisfy the conditions of IRC § 2503(c) (1976), see *Harris v. Commissioner*, 461 F.2d 554 (5th Cir. 1972) (taxpayers failed to prove that amended instrument conformed to original intent); *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7th Cir. 1968) (reformation ineffective); *Davis v. Commissioner*, 55 T.C. 416, 428 (1970) (same, citing other cases). But see *Touche v. Commissioner*, 58 T.C. 565 (1972) (document conveyed larger interest in property than intended; held, no completed gift of excess, in absence of detrimental reliance on conveyance by innocent parties).

92. See *Heidrich v. Commissioner*, 55 T.C. 746 (1971) (*acq.*).

93. See Treas. Reg. § 25.2503-4(b)(1) (1958).

in a more demanding fashion. If discretionary expenditure authority is vested in a trustee, the trust may not impose any "substantial restrictions" on the exercise of that discretion.⁹⁴ Thus, authority to defray the minor's medical expenses or emergency needs is insufficient; the authority must be comparable to a guardian's power under local law to use the property and its income for broad purposes, such as the minor's care, support, maintenance, and welfare.⁹⁵

Although the trustee must be given the authority to spend for these purposes, exercise of this authority need not be mandatory. For this reason, it seems likely that some, if not all, of the trust provisions that have been held too narrow did not reflect a deliberate effort by the donor to limit the purposes for which expenditures could be made, but instead merely listed the uses that happened to be uppermost in the donor's mind when the instrument was drafted or that were carried over without thought from some earlier document in the lawyer's file. In most cases use of the broad language endorsed by the IRS in a 1967 ruling⁹⁶ will ensure an exclusion without any damage to the donor's intended dispositive pattern, particularly since the trustee can be given untrammelled discretion to accumulate the funds instead of spending them for the purposes specified.

2. *Distribution of Unexpended Property and Income to Donee at Twenty-one*

The requirement of IRC section 2503(c)(2)(A) that the property and the income therefrom, to the extent not expended by or for the benefit of the donee while a minor, pass to the donee at age 21 serves to ensure that any discretionary powers vested in the trustee will continue only during the donee's legal disability and will terminate when they are no longer necessary or appropriate. In keeping with this objective, the IRS has ruled that IRC section 2503(c)(2)(A) is satisfied if the unexpended assets will pass to the donee before the age of 21, for example, at 18, if that is the local age of legal emancipation.⁹⁷

94. *Id.*

95. See *Ross v. United States*, 348 F.2d 577 (5th Cir. 1965) (power to use fund for "support, maintenance, and education" comparable to guardian's power under state law; exclusion allowed); Rev. Rul. 67-270, 1967-2 C.B. 349 (discretionary power to use principal and income for donee's "support, care, education, comfort and welfare" qualifies; terms that have no objective limits, like "welfare," "happiness," and "convenience," qualify if when read as a whole they approximate the scope of the statutory term "benefit"). But see *Faber v. United States*, 439 F.2d 1189 (6th Cir. 1971) ("accident, illness or other emergency" too narrow); *Pettus v. Commissioner*, 54 T.C. 112 (1970) (principal payable when needed by reason of "illness, infirmity or disability"; not qualified, but income interest qualified because payable for "the benefit of" the minor); Rev. Rul. 69-345, 1969-1 C.B. 226 (requirement that trustee take other resources and payments into account is more restrictive than limits on guardian under state law; held, exclusion denied). *Williams v. United States*, 378 F.2d 693 (Ct. Cl. 1967) (approving power to provide for minor's "maintenance, education, medical care, support and general welfare" if not otherwise adequately provided for), might seem inconsistent with Rev. Rul. 69-345, but the trustee's power was evidently viewed by the court as consistent with the local law rules governing expenditures by a guardian of a minor's assets.

96. Rev. Rul. 67-270, 1967-2 C.B. 349.

97. Rev. Rul. 73-287, 1973-2 C.B. 321 (IRC § 2503(c) (1976) prescribes the "maximum restrictions" consistent with present interest status).

The regulations provide that IRC section 2503(c)(2)(A) is consistent with a provision allowing the donee, on reaching age 21, to extend the life of the trust,⁹⁸ for example, by providing that the trustee's discretionary expenditure powers will continue until the donee reaches age 35 and that final distribution will be made at that time. In *Heidrich v. Commissioner* the Tax Court held that a trust complied with IRC section 2503(c)(2)(A) even though it would continue until the donee reached age 25, when the donee had the right at any time after reaching age 21 to terminate the trust by written notice to the trustee.⁹⁹ *Heidrich* is consistent with other tax cases holding that the power to obtain property on request is tantamount to ownership;¹⁰⁰ the IRS has not only acquiesced in the decision, but has gone somewhat beyond it by ruling that an exclusion is allowable under IRC section 2503(c) even if the donee's power to compel immediate distribution of the trust assets is not a continuing power, as in *Heidrich*, but must instead be exercised within a limited period after the donee reaches age 21.¹⁰¹ For practical purposes this no doubt means that many discretionary trusts will continue by their own terms until the donee is age 25, 30, or even older since the power to terminate the trust is likely to lapse in many cases, especially since the ruling does not require the donee to be given timely notice of the power.

3. *Disposition if Donee Dies Before Age Twenty-one*

If the donee dies before attaining age 21, IRC section 2503(c)(2)(B) requires the unexpended property and income therefrom to be payable to the donee's estate or to those persons the donee may appoint under a power of appointment meeting the standards of IRC section 2514(c). Both of these dispositions, which are statutory alternatives, ensure that the distribution will be includible in the donee's gross estate for federal estate tax purposes.¹⁰² The estate alternative, however, is not satisfied by provisions requiring the unexpended amount to be distributed to the donee's living descendants, next of kin, or heirs at law, since these takers are not identical with those who would receive the assets in the event of a qualifying distribution to the donee's estate.¹⁰³ The disparity arises because property distributed to the donee's estate would be subjected to the donee's unpaid debts, and the balance would go to the donee's testamentary successors or pursuant to the law of descent and distribution in case of intestacy.

98. Treas. Reg. § 25.2503-4(b)(2) (1958).

99. 55 T.C. 746 (1971) (*acq.*).

100. See *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

101. Rev. Rul. 74-43, 1974-1 C.B. 285 (revoking the automatic termination rule of Rev. Rul. 60-218, 1960-1 C.B. 378, which disqualified gifts if the donee was required to take positive action to obtain a distribution of the transferred property).

102. See *Ross v. Commissioner*, 652 F.2d 1365 (9th Cir. 1981).

103. *Id.* (heirs at law); *Clinard v. Commissioner*, 40 T.C. 878 (1963) (next of kin); *Heath v. Commissioner*, 34 T.C. 587 (1960) (living descendants).

If the donor relies on the power of appointment alternative to qualify the disposition under IRC section 2503(c)(2)(B), the power must meet the broad standards of IRC section 2514(c) and, while it can be subject to such local rules as a prohibition on exercise by minors, it cannot contain more severe restrictions of a substantive nature.¹⁰⁴ For example, a power exercisable only in favor of the donor's descendants and their spouses does not qualify, nor does a power that is not exercisable until the donee is 19 years old if local law permits exercise by married persons over age 18.¹⁰⁵ On the other hand, a power qualifies even if it is exercisable only during the donee's lifetime or only by will, and the takers in default can be specified by the donor.¹⁰⁶

4. *Meaning of "Property and the Income Therefrom"*

At first blush the statutory requirement that "the property and the income therefrom" must be subject to the expenditure authority described by IRC section 2503(c)(1) and that any unexpended amount must pass as prescribed by IRC section 2503(c)(2) seems to encompass the entire gift. This all-or-nothing interpretation was rejected by the courts in *Herr v. Commissioner*¹⁰⁷ and several other cases.¹⁰⁸ The IRS also conceded in a 1968 ruling that a minor's right to receive the income of a trust is property within the meaning of IRC section 2503(c) that can qualify for an exclusion, even if the minor has no interest in the corpus, provided that the income can be used for the minor's benefit before age 21 and that any accumulated income will be distributed to the donee at age 21 or to the donee's appointees under a general power of appointment, as required by IRC section 2503(c)(2).¹⁰⁹ Thus, a minor's interest in the income of a typical 10-year Clifford trust can qualify for an exclusion under IRC section 2503(c), even though the trustee can accumulate the income for the minor until the trust terminates and the corpus will revert to the donor at that time.¹¹⁰

Surprisingly, the 1968 ruling does not explicitly require accretions to the accumulated income to be expended or distributed along with the accumulated income since the rationale of the *Herr* case—that the minor's interest in the trust income is property—accounts for only part of the statutory phrase ("property and the income therefrom").¹¹¹ Unlike the ruling, the *Herr* court

104. Treas. Reg. § 25.2503-4(b) (1958).

105. See *Ross v. Commissioner*, 652 F.2d 1365 (9th Cir. 1981) (appointees limited to donor's descendants and their spouses); *Gall v. United States*, 521 F.2d 878 (5th Cir. 1975) (power exercisable only after age 19), *cert. denied*, 425 U.S. 972 (1976).

106. Treas. Reg. § 25.2503-4(b) (power can be exercisable either during life or at will), -4(b)(3) (takers in default) (1958).

107. *Commissioner v. Herr*, 303 F.2d 780 (3d Cir. 1962).

108. See, e.g., *Commissioner v. Thebaut*, 361 F.2d 428 (5th Cir. 1966); *Rollman v. United States*, 342 F.2d 62 (Ct. Cl. 1965).

109. Rev. Rul. 68-670, 1968-2 C.B. 413.

110. See, e.g., *Weller v. Commissioner*, 38 T.C. 790 (1962) ("property" consists of minor's interest in trust income for 10 years and 90 days or until prior death) (*acq.*); accord Rev. Rul. 68-670, 1968-2 C.B. 413.

111. *Herr v. Commissioner*, 35 T.C. 732, 736 (1961) (*acq.*), *aff'd*, 303 F.2d 780 (3d Cir. 1962); see also *Konner v. Commissioner*, 35 T.C. 727, 731 (1961) (*acq.*).

explicitly referred to accretions to any accumulated income and presupposed that they would be aggregated with the income for purposes of later expenditures and distributions.¹¹²

Herr and the 1968 ruling accepting its rationale permit gifts to be split into two components, income and principal, to qualify the income interest for an exclusion if it satisfies the requirements of IRC section 2503(c), even if the gift of the remainder does not meet the statutory standards. However, the corpus does not automatically qualify apart from the income interest. Assume, for example, that a trust is created, the income of which can be used to defray a son's emergency needs until age 21 but must otherwise be accumulated for him until then (a disqualifying restriction)¹¹³ and the principal of which may be expended for the benefit of the donor's daughter during her minority and must, if not expended, be distributed to her at age 21 or, in the event of her prior death, to her appointees under a general power of appointment. Although the gift of the principal can be tested under IRC section 2503(c) apart from the unqualified gift of the income, it does not easily fit the statutory reference to "property and the income therefrom"; the principal is property, to be sure, but by hypothesis it will generate no income to be expended for the daughter's benefit or to be distributed to her when she reaches age 21 or to her appointees if she dies earlier.¹¹⁴

In *Estate of Levine v. Commissioner* the Court of Appeals for the Second Circuit rejected a donor's attempt to build on the separable property concept accepted in *Herr* to qualify two otherwise disqualified interests—a right to the income accruing during the beneficiary's minority, which was to be accumulated by the trustee and paid to the beneficiary on reaching age 21, and a right to receive the income annually from age 21 to age 25, when the trust was to terminate.¹¹⁵

Noting that the beneficiary's right to receive the accumulated income at age 21, though a future interest when taken in isolation, qualified for the exclusion because it satisfied the requirements of IRC section 2503(c), the donor argued that the post-21 income, though also a future interest when taken in isolation, was purified by the qualifying status of the pre-21 income.¹¹⁶ It was, of course, true that if the beneficiary had been entitled to receive the pre-21 income annually, rather than only at age 21, the post-21 income would have been an integral part of a qualifying present interest. Even so, the *Levine* court held that the beneficiary's right to receive the pre-21 income, having been severed to be tested separately under IRC section 2503(c), was only a constructive present interest that could not be combined

112. *Herr v. Commissioner*, 35 T.C. 732, 737 (1961).

113. See *supra* note 92.

114. *But see* *Pettus v. Commissioner*, 54 T.C. 112, 121-22 (1970) (noting in dictum that the corpus can qualify).

115. *Estate of Levine v. Commissioner*, 526 F.2d 717 (2d Cir. 1975).

116. *Id.* at 720.

with the beneficiary's right to the post-21 income into a unitary present interest.¹¹⁷

The issue in *Estate of Levine* arose, it should be noted, only because the beneficiary's interest in the pre-21 income was worth less than 3,000 dollars (the amount of the exclusion then allowable), so that the donor wished to apply the unused portion of the exclusion to the donee's interest in the post-21 income. To illustrate the point using dollar amounts relevant to the post-1981 exclusion of 10,000 dollars, assume that 15,000 dollars are transferred in trust for an 11-year-old beneficiary, income to be accumulated and distributed to the beneficiary at age 21 and then to be paid annually to age 25, when the beneficiary is to receive the corpus. The right to receive the accumulated income at age 21 is worth about 6,624 dollars, the right to receive the income from age 21 to age 25 is worth about 2,118 dollars, and the right to receive the corpus at age 25 is worth about 6,258 dollars.¹¹⁸ Under the theory advanced by the donor in *Estate of Levine*, the first two of these amounts, totalling 8,742 dollars, would qualify for the exclusion, leaving a taxable gift of only 6,258 dollars—15,000 dollars less 8,742 dollars. The court held, however, that only the first amount qualifies, resulting in a taxable gift of 8,376—15,000 dollars less 6,624 dollars.

This disparity could not arise, however, if the beneficiary's right to receive the accumulated pre-21 income was worth 10,000 dollars or more, since then the exclusion could be fully utilized. If, for example, the amount transferred was 30,000 dollars rather than 15,000 dollars, the present value of the accumulated pre-21 income would be 13,248 dollars; and the taxable gift would then be 20,000 dollars, even under *Estate of Levine*.

D. State Custodianship Statutes

Gifts to minors have been greatly facilitated in recent years by the enactment in many states of the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, and the Revised Uniform Gifts to Minors Act, which permit donors to avoid the administrative inconvenience of outright gifts to minors, the expense and judicial supervision of legal guardianships, and the formality of common-law and statutory rules applicable to trusts.¹¹⁹ The simplifying device authorized by these statutes is a transfer of the property to a custodian, who can be the donor, another adult individual, or a bank or similar institution with broad statutory authority to use the property and

117. *Id.* at 721.

118. Treas. Reg. § 25.2512-9 Table B (1970). To simplify the computations in the text, the income interests are treated as terms certain, without regard to mortality.

119. See Newman, *The Uniform Gifts to Minors Act in New York and Other Jurisdictions—Tax Consequences, Possible Abuses, and Recommendations*, 49 CORNELL L.Q. 12 (1963); see also Commissioner's Prefatory Note, 8 U.L.A. 182-86 (1972). See generally Ziegler, *Gifts to Minors—Three Variations*, 24 TAX LAW. 297, 299-316 (1971).

the income therefrom for the minor's benefit with a minimum of legal supervision. Any unexpended income and principal are payable to the beneficiary at age 21 or, in the event of prior death, to the beneficiary's estate.

The IRS has ruled that gifts under these statutes, which vary in details but not in basic principles, are completed gifts to the beneficiaries and that an exclusion is warranted under IRC section 2503(c) because the custodian has the requisite authority to use the property and income for the minor's benefit until age 21, as required by IRC section 2503(c)(1), and must distribute any unexpended amount to the donee at age 21 or to the donee's estate in the event of prior death, as required by IRC section 2503(c)(2).¹²⁰

Departures from the basic custodianship pattern, of course, might disqualify the gifts under any particular state's version of the model statutes. The IRS has ruled, however, that a statutory reduction of the age when the property will pass to the donee from age 21 to age 18, to accord with a state's laws regarding adulthood, does not violate IRC section 2503(c) and that gifts pursuant to the amended model statute continue to qualify for the exclusion.¹²¹

120. See Rev. Rul. 59-357, 1959-2 C.B. 212, and earlier rulings there cited.

121. Rev. Rul. 73-287, 1973-2 C.B. 321.

